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November 10, 2010

Commissioner Paul Newman
Arizona Corporation Commission
1200 West Washington
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RE: Your letter dated November 2, 2010 regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures, Docket Nos. G-00000C-08-0314 and E-00000J-08-0314

Dear Commissioner Newman,

This responds to the questions posed in your letter to Arizona Public Service Company ("APS" or "Company") dated November 2, 2010. As you will recall, APS was prepared to respond at the November 4th Special Open Meeting, but time did not permit such response.

APS's Response to General Questions Posed in Your Letter

You asked stakeholders to address which customer classes should be included in a decoupling mechanism. APS supports the draft language in Policy Statement 11, which states that "broad participation in decoupling is preferred; however, the unique characteristics of each utility may merit different treatment of some customer classes." This statement provides each utility the requisite flexibility to analyze their customer classes and determine the appropriate treatment. Fundamentally, because all customer classes have the opportunity to participate in energy efficiency programs, APS believes any customer class excluded from future decoupling adjustments should otherwise pay for non-fuel costs through rate design or other rate mechanisms.

APS's Responses to Questions Posed to Parties and Stakeholders

Commissioner Newman Question #1: How would decoupling be affected in a low or no-growth scenario?

Response:

The revenue per customer decoupling mechanism that APS supports and that is endorsed in the ACC draft Policy Statement decouples or breaks the link between volumetric sales and revenues and re-couples revenues to the number of customers. Therefore, under a revenue per customer decoupling mechanism, low or no-growth in volumetric sales would have no

effect on the authorized fixed cost revenue requirement (i.e. non-fuel costs) that a utility would collect, because the link between volumetric sales and revenues is severed. Instead, the only variable that effects an adjustment is the usage per customer. For instance, if the usage per customer declines below that of the test year, then customers will pay a decoupling surcharge. Conversely, if the usage per customer increases beyond that of the test year, customers will receive a decoupling credit.

Commissioner Newman Question #2: During the presentations, Wayne Shirley from RAP presented information that a mere 2% drop in sales would result in an astounding 24% in profits; while a 5% drop in sales would result in a 59% drop in profit. Do the parties and stakeholders agree with Mr. Shirley's estimation?

Response:

APS agrees with the implications of this example. While each utility has specific and unique characteristics that will affect the precise relationship between sales and earnings, the magnitude and effect on earned returns from decreased sales due to the vigorous pursuit of energy efficiency is significant no matter how you calculate it. Mr. Shirley's simple example attempts to demonstrate how small changes in volumetric sales, with other variables held constant, can have a *significant* effect on a utility's earnings. Further, Mr. Shirley's analysis is evidence that utilities have a considerable disincentive to promote energy efficiency without some mechanism to help recover the fixed costs of service it has been authorized to collect. APS believes the nation's most aggressive Energy Efficiency Standard ("EES") cannot be achieved without an offsetting mechanism, such as decoupling, to help utilities recover their fixed costs.

Commissioner Newman Question #3: During the April 15-16, 2010 workshops, utilities stated that environmental benefits would accrue from deferring new generation infrastructure. What specific 'environmental benefits' would the utilities include? For example, would the cost of transportation and disposal of coal ash; or reduced mercury and hazardous air pollutants, sulfur dioxides and nitrogen oxides be included?

Response:

The specific environmental benefits that would be deferred due to the implementation of the EES are dependent upon the type of plant(s) deferred in each utility's resource plan. For instance, if a gas-fired unit was deferred, the associated environmental benefits would be decreased water consumption and reduced air emissions for nitrogen and carbon oxides. Regardless of the type of plant(s) deferred, the Commission-approved EES will help to reduce a utility's overall environmental footprint.

Commissioner Newman Question #4: Please explain at in plain language at the Open Meeting where this will be discussed how the "dead-band" concept works.

Response:

In the workshops, the terms "dead-band" and "cap" were used interchangeably. A cap is a threshold on how much of an adjustment can be passed on to customers in a given period. Caps are commonly used to help provide customers with greater rate stability in the event that there are large variations in an adjustment.[1] If an upward or downward adjustment exceeded the cap, customers would only receive an adjustment at the cap level, instead of the full amount. Any amount in excess of the cap would be deferred for recovery or credit in the subsequent period. The draft Policy Statement 14 suggests adjustments that would increase customer bills should be subject to a cap, but in the event of a credit, the full amount should be applied to customer bills without restriction.

APS's Response to Questions Posed to AECC

Commissioner Newman Question #8: Could decoupling be designed so that it takes into account the fact that industrial classes do not contribute to fixed costs? Should the fact that industrial classes do not contribute to fixed costs be addressed in upcoming rate cases?

Response:

While Mr. Crockett, on behalf of AECC, addressed this question and correctly noted that industrial classes *do* contribute to fixed costs, APS wanted to further comment on this question. Every customer in the APS system has fixed costs. Although each class's fixed costs may be comprised of a different subset of costs, each class most certainly does have fixed costs. For example, many industrial customers fixed costs are comprised of generation and transmission costs, whereas residential customers, in addition those costs previously mention, also have distribution fixed costs.

Lastly, for the most part the fixed costs for industrial customers are recovered through demand charges, whereas most residential customers' fixed costs are recovered through volumetric energy charges. Since industrial customers typically have high load factors (i.e. high energy sales compared to demand levels) when contrasted to residential customers, rate comparisons based on average cents per kWh can lead to erroneous conclusions. Indeed, industrial customers do generally pay for their fixed costs.

APS's Response to the Question related to the Affect of Climate Change and Weather

Commissioner Newman Question #11: Global climate change is real, and it is affecting Arizona and the Southwest. A March 2008 report by NRDC titled *Hotter and Drier; The West's Changed Climate,* states that in the five-year period from 2003 to 2007, Arizona's average temperature increased a stunning 2.2 degrees Fahrenheit as compared to 20th century averages. Do the

[1] The APS Power Supply Adjustment Mechanism has a reciprocal cap of plus/minus four mils per kWh in any single adjustment.

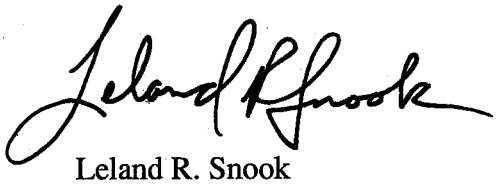
utilities have a plan to continue to monitor the increased temperatures and drought predicted by the Intergovernmental Panel on Climate Change?

Response:

Yes. When APS conducts system planning analyses, a multitude of inputs and environmental impacts are considered, such as temperature change and potential drought conditions. For instance, system facilities are designed to operate safely over a broad range of temperatures. The temperature changes predicted by the Intergovernmental Panel on Climate Change would fall within this range. System reliability is very important to APS, therefore incorporating inputs of numerous potential future events into the planning process is necessary. Further, the recently certified Integrated Resource Planning rules require utilities to account for various environmental externality impacts when making resource decisions.

If you have any questions regarding these comments, please contact me at (602) 250-3730.

Sincerely,



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LRS/sl

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